



What readers want to know from annual reports

Announcer:

Hello, and welcome to the CPA Australia podcast. Your weekly source for accounting, education, career and leadership discussion.

Ram Subramanian:

Hello and welcome. I'm Ram Subramanian, Policy Adviser - Reporting at CPA Australia. For this podcast, we are joined by two academics from Swinburne University of Technology, Dr Janine Muir and Dr Mark Shying.

Dr Janine Muir is a Lecturer in Accounting in the Swinburne Business School with 15 years industry experience encompassing transport and logistics and publishing. Janine's PhD examined volunteer accounting in an unregulated environment, looking at the accounting function in small Victorian incorporated associations, with a focus on community sporting clubs.

Dr Mark Shying is an Industry Fellow within the Department of Accounting, Economics and Finance, Swinburne Business School. A key focus of Mark's position is industry engagement. Research related activities include forging industry partnerships for research and teaching endeavours.

Just over a year ago with CPA Australia's support, Swinburne University of Technology embarked on a research project, exploring the decision usefulness of annual reports produced by unlisted for-profit entities, such as large proprietary companies and unlisted public companies. A report setting out the research findings has just been published, and Janine and Mark are here to throw further light on the research findings. Welcome Janine and Mark.

Janine:

Hi Ram.

Mark:

Hi Ram.

Ram Subramanian:

Okay. If I could just probably kick off with a general question. Annual financial reporting in Australia is done by a broad range of entities in different settings and different sectors, and they prepare these annual reports for a number of different reasons. Perhaps if we could start off with why you undertook this project, this research project and what the scope of the project is. And maybe Mark, if I could throw that question to you.

Mark:

Yes. Thanks Ram. Well, I have a deep interest in company reporting and the same could be said for my research colleagues from Swinburne Business School. And as you know, and many of our listeners know, there is a significant body of literature that addresses various aspects of listed company reporting. In

fact, CPA Australia has supported some of that research. But in contrast, there's a lack of literature and a lack of understanding about which particular pieces of information in the annual reports of unlisted Australian for profit entities, are used by different users when making decisions. And so the purpose of our research is aimed at addressing that deficiency and understanding. So the way we went about that was we developed an online survey, which we used a system called Qualtrics to capture the views of respondents. And in fact, we had 55 respondents and I can assure you that that number of 55 allows us to statistically analyse the responses received and to report our findings.

And then as a final note here, I mean, I'd just like to say that through the survey, we asked questions that were designed to show the level of importance users attached to the different pieces of information in the annual report when making decisions. And also we were able to use, within Qualtrics, an experimental design to test for the influence of two different accounting standard frameworks. And those different accounting standard frameworks, where the Reduced Disclosure Requirements standard that is issued by the Australian Accounting Standards Board, the framework that's issued by the Australian Accounting Standards Board and the IFRS for SME standard, which is a framework issued by the International Accounting Standards Board.

And we were looking at the influence of the two different accounting standard frameworks on the usefulness of financial information when making decisions. So the way that we did that was to develop a case study, being the financial report of a hypothetical proprietary limited company. It was simplified obviously, because we didn't want a 50 page financial report, but simplified with selected notes and supported information. And that was used for the purpose to test for the influence of the two different accounting standard frameworks.

Ram Subramanian:

The key question the research project is exploring is around what readers of annual reports do with the information they obtain from such reports. Can you tell us a bit about what your research found in answer to this question, Janine?

Janine:

Yes. Thanks Ram. In this area, we really had two aspects that we explored. First of all, we considered the components of the annual report used as a source of information about unlisted Australian for profit entities. And here the respondents or users, were asked to indicate the components of the annual report they use as a source of information about the entity. They could list as many as appropriate and revealed that the top three sources of information about the entity in the annual report, where first of all, the financial report and the director's report, and then followed by the auditor's report. Now, as you'd expect some of the users, indicated the use of more than one component from the annual report.

So we next examined their responses to identify the component attributed the largest percentage. So from this, we're able to identify that the single most important component in the annual report with regards to understanding the entity was indeed the financial report, quite as a standout. That's not to say that the director's report and the auditor's report, weren't also important as just the single most important component was indeed the financial report.

So now that we know that the relative importance of the various components of the annual report to gaining that understanding of the entity, we then explored a bit further as to the types of decisions being made, using the information in the annual report. Now, once again, we applied a two stage approach. First of all, we explored what type of decisions are being made using the annual report. And for this, we listed seven suggestions then left an other option, so that we could capture detailed and greater insight. In doing this, we found that the top five decisions made using the annual report

where first of all, analysing and providing recommendations. Second was monitoring or assessing the performance of those responsible for the governance of the entity. Third was the monitoring and assessing the performance of those responsible for managing the entity. Next came regulatory compliance decisions, followed by equity investment decisions. So within those, they range, the analysing and providing recommendations was at 23%, the governance of the entity, 19%, managing the entity 16%, the regulatory compliance, 13% and equity decisions, 10%.

So there wasn't a clear standout in these responses. So we did delve further into the responses and what we found there was that the most important type of decisions made using the annual report was indeed analysing and providing recommendations. And this time it really was a standout. It received double the amount of responses to equity investment decisions, which was the next main important decision. So we found that the financial report, directors' report, auditor's report are all used as sources of information about Australian unlisted for profit entities. And ultimately the decisions being made based on information in the components, is quite varied and encompassing those analysis recommendations and monitoring of governance and management.

Ram Subramanian:

Okay, thank you, Janine. So the report has looked at the five most important decisions made by users when they are looking at annual reports of unlisted for profit entities. Maybe if I can delve into that a bit more. Although there is no single definition for what an annual report is. We generally have an understanding of the kinds of information that is included in annual reports. And of course, one key component of an annual report is the financial report. Based on your research, how do users of annual reports perceive the financial report compared to other parts of the annual report, Janine?

Janine:

Yeah. Well, we're actually really very keen to see where this one landed. To gain some insights into the perceptions, respondents were asked to indicate the component or components of the annual report used when making their most important decision. The results indicated that the financial report is perceived to be very important to use as most important decision. In fact, the findings revealed that the financial report is the most important component of the annual report when making that most important decision. And to give you a bit of an idea as to how we arrived at this, we first asked which components of the annual report are used for making the most important decision. And from that, we found that the top three responses or components were the financial report, the directors' report, and the auditor's report, with the financial report sitting at 40%, directors' report, 29% and auditor's report, 28%.

So from that, when we drilled down a bit further and we ascertained that the financial report is the most important component of the annual report when it comes to making the most important decision. And here, it was a clear standard out, with the financial report getting 84% of the votes and directors' report and auditor's report 7% and 4% respectively. So, that's what that found. But in order to gauge the perceptions about the usefulness of the financial report, users were also asked to indicate the importance of the financial report when compared with information from sources outside the annual report, when making their most important decision. Now, all the financial accountants listening will be thrilled to know that we found users assess the financial report as the most important to their most important decision, more so than information from sources outside of the annual report.

Ram Subramanian:

Okay. And obviously the financial report is made up of elements, and one of the elements is financial statements. A financial report itself is a defined term in the Corporations Act. And how do users perceive the information in financial statements that are part of financial reports, Janine?

Janine:

Well, in short, they view the information favourably. When we were looking at this, users were asked to indicate the importance of the pieces of information that made up the financial report when making their most important decision. Now, we got them to do this, using a Likert scale of one to five, where five being extremely important and one not important at all. And the elements were the primary financial statements for the current year, primary financial statements for the comparative year, notes to the primary financial statements and the directors' declaration. What we found here was that the most useful information in the financial report used for the most important decision, was the current year financial statements. But this was closely followed by the notes to the financial statement and then followed by the financial statements, comparative information. So the standard here was the directors' declaration was really not in the same level of usefulness, I guess, for that most important decision. But the current year financial statement's very important.

Ram Subramanian:

A little while ago, you just mentioned the auditor's report as part of the annual report and provided some statistics around the usefulness of the auditor's report. It's another important element of the annual report, of course. What does your research tell us about the importance of the information provided in the auditor's report, Janine?

Janine:

Well, all the auditors listening and I guess indeed all those businesses paying for assurance services will be thrilled to know that the information in the auditor's report is important to the understanding of the entity. And that was a 26% response rate. So very clear responses there. So having said that, as I previously mentioned, the auditor's report is not the most important source of information for understanding the entity, but it is clearly an important piece of information to that understanding. We also can confirm from the research that information in the auditor's report is important for making their most important decisions as well. Again, this time it was 28%. So although not the most important component for the most important decision, it certainly came out in the research findings that it was indeed, important for making the most important decisions.

Ram Subramanian:

Mark, if I may turn to you, did your research explore non-financial information contained in an annual report and how such information may provide value to readers?

Mark:

Well, not directly Ram. Certainly a small number of respondents identified their use of non-financial information found in the annual report as the most information to understand the entity. And also non-financial metrics were identified as a component of information sourced from outside of the annual report. So what is clear is that some respondents see non-financial information as part of the annual record, while other see this information as existing outside of the annual report.

Now, I think it's fair to say that our survey instrument may have actually coloured those findings because the survey instrument included a definition of annual report, and that definition may have

influenced the way some respondents thought about the place of non-financial information in the annual report. So Ram, my takeaway from this is that that influencing factor, which was the way in which we define the annual report, is something that researchers with an interest in non-financial information and annual reports need to be cognizant of, when exploring their research interests.

Ram Subramanian:

And Mark, to me, this is an interesting aspect of the project, which you, I think touched on earlier. The research undertook a comparative analysis of the value of information provided to a set of financials prepared using the Australian Accounting Standards, Reduced Disclosure Requirements framework, or the RDR framework, against the value of information provided through a set of financials prepared using the IFRS for SMEs framework, the International Financial Reporting Standard for small to medium-sized enterprises framework. How do the two frameworks compare, based on your findings, Mark?

Mark:

Well, yeah, thanks for this question Ram. Perhaps if I could just backtrack a little. As you said, I've mentioned earlier that some of our survey questions were designed to test for the influence of those two frameworks. And as you've said, it's the RDR framework and the IFRS for SME framework on the usefulness of financial information when making decisions. And we developed that case study, which was the financial report of a hypothetical proprietary limited company, simplified with selected notes and some audit information.

So let me speak briefly how we did our comparative analysis and then I'll speak to the results. So 55% of the respondents to our survey received the version of the case study that complied with the RDR standard, whereas 45% received a version of the case study that complied with the IFRS for SME standard. So they were randomly allocated among respondents.

And what we asked of the respondents was to first think about their most important decision-making task. Then second, to read the provided financial report, and then third, assess the relevance and representational faithfulness of eight items of financial information, to their decision. So the assessment of relevance and representation of faithfulness reflects the fact that they are the key qualitative characteristics of useful information, identified in the conceptual framework for reporting. And just to give an example of the eight items that we were asking them to assess, they included items such as revenue, profit before income tax, tangible non-current assets, goodwill, among others.

So respondents were asked to indicate their assessment on a scale of one to five. So again, it was using a Likert scale where five is strongly agree and one is strongly disagree. So now if I turn to the results, so the RDR standard group generally awarded higher relevance and representational faithfulness assessment scores, compared to those awarded by the IFRS for SME standards group. Now, the fact is that there's difference in the mean scores. But what we're interested to understand is whether this difference in mean scores were statistically significant. In effect, we want to drill down into those numbers.

So if I could use an analogy, for the audience, think about the reporting of increased daily COVID-19 infections. We heard chief health officers speaking to something called, R nought, the reproduction number. They use that to describe the intensity of an infectious disease outbreak. If R nought is greater than one, the disease will spread. So rather than just focusing on the daily numbers, there was also this focus on this R nought. So that was drilling down for the purposes of COVID-19 and public health policy.

So getting back to our research, we subjected these mean scores to further statistical tests, and I'm not going to speak to those tests now, particularly other than to identify, they were t-test, one way

analysis of variance and post-op tests. And the results of those tests was that there is no significant difference between the two groups of users at the 0.05 level. So what does this mean for the audience? Well what it says is that for the attributes of relevance and faithful representation, it appears users assess each of the eight items as equals, regardless of which one of the two accounting standards framework is adopted. That is, the difference in the two accounting standards framework, do not influence the usefulness of financial information to users when making decisions.

Now, in our survey, we also asked for standards to assess the relevance and representation of faithfulness of the financial report overall. So this is moving from the eight items to the financial report in totality. So again, response indicated their assessment on a scale of one to five, where five is strongly agree, and one is strongly disagree. And the respondents to the financial report that used the RDR awarded higher relevance and representational faithfulness assessment scores compared to those awarded by respondents to the IFRS for SME standard. Again, we're research to understand whether this difference in mean scores was statistically significant. So again, we used further statistical tests, in this case, the t-test, and one way analysis of variance, and they show no significant difference between the two groups of users at the 0.05 level.

So for the last word, what does this mean? Concerning the attributes of relevance and faithful representation, it appears that users assess each of the two accounting standards frameworks as equals. Consequently, the difference in the two accounting standards frameworks do not influence the usefulness of the financial information to users when making decisions.

Ram Subramanian:

That finding that you just discussed, Mark, about there being no statistically significant difference in the usefulness of information presented, using those two frameworks, and combined that with all the other findings around the usefulness of the various components of the annual report that we've discussed so far. How do you see the research findings contributing to improving Australian financial reporting, Mark?

Mark:

Yeah. Thanks Ram. Well, I think this research is part of a body of research, which is of interest to both regulators and the standard setter. For example, I see this research as complementing the 2018 research project decision usefulness in financial reports that were supported by CPA Australia. And that report, along with this report, I think will be of great interest to ASIC and the AASB. I think we need to keep in mind that some commentators review the requirements for reporting demanded of some entities as being nothing more than a compliance exercise. They doubt the usefulness of these reports, including the financial report to stakeholders, including equity holders and providers of debt.

The evidence collected strongly indicates that the financial report as the most important component of the annual report when making important decisions. So in conclusion, our research provides evidence that the annual reports of unlisted entities are being used for making decisions after they are produced. Evidence, I believe, that can inform policies decisions about regulation and the requirements for financial reporting relevant to such entities.

Ram Subramanian:

Thanks, Mark. That's obviously looking at it from an Australian context and of course we know that Australia is a standard taker, so it adopts international standards for its own reporting requirements in Australia. So do you think your research findings could contribute to the international standard setting scene as well? And if so, how?

Mark:

Yeah, look, I do. I mean, our view is the research findings are relevant to two current projects of the International Accounting Standards Board. The project on the disclosure initiative, subsidiaries that are SMEs and a second project, the IFRS for SMEs standard project. Now how? Well, as I have said previously, a key finding of our research is that the evidence collected shows no statistically significant difference in the usefulness of the information provided in financial statements when prepared using either of two different accounting standards frameworks. It appears that users assess each of the two accounting standard frameworks as equal. Consequently, the differences in the two accounting standards frameworks do not influence the usefulness of the financial information to users when making decisions.

As I've mentioned, we think this finding is particularly relevant to projects of the IASB, the disclosure initiative, subsidiaries that are small and medium sized entities. Specifically, whether the scope of that IASB project should remain solely as subsidiaries that are SMEs, whether it should be extended to all SMEs or whether the project should sit somewhere between the two. And, as already mentioned, we believe that our findings are particularly relevant to the second project, that is, the second comprehensive view of IFRS for SME standard, because it does pose the question, is there a need for the IFRS for SME standard?

Ram Subramanian:

The findings we have discussed today is the first stage of this research project. Mark, are you able to share some insights into what you're planning to do over the remaining stages of this project?

Mark:

Yes. Thanks Ram. So currently we're looking at the reporting by Australian not-for-profit organisations. And so I use that term, not-for-profit organisations quite broadly. So we're certainly not restricted to charitable organisations, but we do include charitable organisations as part of our focus. So our preliminary view is that little is known about how Australian not-for-profit organisations use the annual report to show how they are accountable. Little is known about how the information in the annual report of those Australian not-for-profit organisations is used by external stakeholders, in holding management and those charged with governance accountable in the discharge of their duties, in assessing management and those charged with governance, stewardship of the resources of the organisation, and any other decisions that stakeholders might make when using information in the annual report.

We think the collection of evidence about these matters would be of interest to the Australian Accounting Standards Board and to Australian regulators. And of course in the not-for-profit sector, there are a range of regulators, both at the national and state level. Ram, finally, we're looking for stakeholders to share their ideas and opinions in upcoming, focus group sessions. So to any of our listeners, if they would like to be involved, we'd certainly appreciate them making that offer to be involved. Thanks.

Ram Subramanian:

Thank you for that, Mark. Thank you to you, Mark, and to you Janine as well, for sharing your insights into what I find to be quite an interesting and exciting set of findings from this stage of the research project, looking into unlisted for-profit entities and the usefulness of the financial information and other information that's contained in the annual reports for such entities. And I also eagerly look forward to

hearing and seeing the findings that you're going to come up with in the next stage of the project and the subsequent stages as well.

And for listeners who are interested in participating in the focus groups and other events that we are going to be putting together for the not-for-profit stage of the project, the email address you would need to contact us at is provided on the page where this podcast is, so please do have a look. And if you're interested, send an email to the address, and we'll get in touch with you to let you know about the next steps.

And the link to the research report that we've just discussed, is also available on the same page where this podcast is. So please have a look. And we've also posted a few other relevant resources for you to have a look at, including the decision usefulness in financial reports, a report that Mark mentioned during the podcast recording.

Thank you Janine, and thank you Mark for the podcast today.

Janine:

Fantastic. Thanks Ram, very much.

Mark:

Yeah. Thank you, Ram.

Ram Subramanian:

Thank you, Mark and Janine, once again, and bye for now.

Announcer:

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